

TESTIMONY OF

**DONNA TANOUE
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION**

FEDERAL DEPOSIT INSURANCE REFORM

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

COMMITTEE ON FINANCIAL SERVICES

**U.S. HOUSE OF REPRESENTATIVES
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Chairman Bachus, Representative Waters and Members of the Subcommittee, thank you for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the reform of the federal deposit insurance system. We appreciate the Subcommittee recognizing the importance of this issue and holding hearings so expeditiously. In addition, we appreciate the efforts of several Members of Congress who have introduced or cosponsored legislative initiatives addressing deposit insurance issues. These efforts stimulate and further advance the debate. The best time for constructive debate on changes to deposit insurance is now, during a period of financial health for the banking and thrift industries, rather than in the charged atmosphere of a crisis.

The FDIC has promoted confidence in the U.S. banking system since 1933. Depositors in all walks of life have come to rely on FDIC insurance to guarantee that their deposits are absolutely safe. The FDIC's financial strength, and its ability and commitment to honor its responsibility to depositors, are beyond question.

Given the importance of deposit insurance, changes should be made with great caution, and the FDIC does not believe that the system is in need of radical change. Yet, there are flaws in the deposit insurance system that only can be corrected by legislation. As I will discuss in greater detail later, current restrictions on the pricing of deposit insurance distort economic incentives and increase moral hazard, potentially threatening bank safety and soundness. The current pricing structure also has a distinct procyclical bias that could further undermine economic and financial recovery during an economic

downturn. Finally, there is no mechanism that insures that this important government program is not eroded by inflation over time.

Last year, the FDIC initiated a comprehensive review of the deposit insurance system by issuing an Options Paper that discussed these weaknesses in the system and offered possible solutions. After reviewing the public and industry feedback to the Options Paper and analyzing the advantages and disadvantages of the possible solutions, the FDIC published its recommendations for reforming our deposit insurance system on April 5, 2001.

In arriving at these recommendations, the FDIC was guided by a number of principles. First and foremost, deposit insurance should enhance—not harm—macroeconomic and financial stability. Second, deposit insurance should be priced in a way that it does not encourage banks to take risks that they would not take in the absence of deposit insurance. Finally, in order to protect the United States taxpayer, the deposit insurance system must be adequately funded.

The FDIC's recommendations include the following reforms:

- The current statutory restrictions on the FDIC's ability to charge risk-based premiums to all institutions should be eliminated; the FDIC should charge premiums on the basis of risk, independent of the level of the fund.
- Sharp premium swings triggered by deviations from the designated reserve ratio should be eliminated. If the fund falls below a target level, premiums

should increase gradually. If the fund grows above a target level, funds should be rebated gradually.

- Rebates should be determined on the basis of past contributions to the fund, not on the current assessment base.
- The Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) should be merged.
- The deposit insurance coverage level should be indexed to maintain its real value.

Collectively, these recommendations will result in a deposit insurance system that will allocate the assessment burden more smoothly over time and more fairly across institutions. They are not designed to increase the long-term net amount of assessments collected.

In this testimony, I wish to focus on the essentials—why the system needs to be changed, how in broad terms it should be changed, and what issues need to be resolved in order to implement those changes. It is important to note that the reforms recommended by the FDIC will be most effective if implemented as a package. Picking and choosing among the parts of the proposal without focusing on the interaction between the various recommendations could weaken the deposit insurance system, magnify macroeconomic instability, and distort economic incentives.

THE CASE FOR REFORM

Historically, federal deposit insurance conformed to two fundamental insurance principles. First, it assessed insurance premiums in good times and bad, and used the funds to pay for bank and thrift failures. Second, the costs of operating the system and paying for failures of insured institutions were spread among all insured institutions.

One of the key flaws in today's system is that deposit insurance premiums do not reflect the risk that individual institutions pose to the system. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) sought to address this flaw by mandating the development and implementation of a risk-based deposit insurance premium system. FDICIA also established a statutorily designated reserve ratio (DRR) of 1.25 percent.¹ However, the Deposit Insurance Funds Act of 1996 (the Funds Act) mandated that institutions that are both well-capitalized, as defined by regulation, and well-managed (generally those with the two best examination ratings) should not be charged premiums when a fund's reserve ratio is at or above the DRR. Under this statutory provision, over 92 percent of insured institutions are in the FDIC's best-risk category and currently pay no deposit insurance assessment, thus rendering the risk-based premium system ineffective.

By enacting the FDICIA risk-based premium system, Congress stated its intent that risk-based premiums be one of the key tools used by regulators to reduce moral

¹ The reserve ratio is the fund balance divided by the dollar volume of estimated insured deposits. For example, the Bank Insurance Fund at year-end 2000 had a balance of \$31 billion and it insured \$2.3 trillion of deposits, resulting in a 1.35 percent reserve ratio.

hazard by managing risk in insured depository institutions. Congress was correct in identifying the importance of risk-based premiums, and thus the law needs to be changed to allow us to carry out this mandate, as originally provided for in FDICIA.

In addition to making the FDICIA risk-based premium system ineffective, the inability to price risk appropriately has had a number of other negative effects. Since very little in premiums has been collected since 1996, the deposit insurance system is almost entirely financed by those institutions that paid premiums in the past. There are currently over 900 newly chartered institutions, with over \$60 billion in insured deposits, that have never paid premiums. In addition, deposit insurance that is underpriced creates an incentive for institutions to grow rapidly.

Since they are not paying for insurance, new institutions and fast-growing institutions are benefiting at the expense of their older competitors and slower-growing competitors. Rapid deposit growth lowers a fund's reserve ratio and increases the probability that additional failures will push a fund's reserve ratio below the DRR, resulting in a rapid increase in premiums for all institutions.

The second flaw in the current deposit insurance system identified by the FDIC study is that premiums are volatile and are likely to rise substantially during an economic downturn. Under FDICIA, when a deposit insurance fund's reserve ratio falls below the DRR, the FDIC must raise premiums by an amount sufficient to bring the reserve ratio back to the DRR within one year, or charge at least 23 basis points until the reserve ratio

meets the DRR. However, during a period of heightened insurance losses, both the economy and depository institutions in general are more likely to be distressed. A 23 basis point premium at such a point in the business cycle could be a significant drain on the net income of depository institutions, thereby impeding credit availability and economic recovery. Allowing the insurance fund to absorb some of the losses temporarily, and increasing premiums more gradually than is required at present, would soften the blow of an economic downturn—which is one of the primary reasons for having an insurance fund. In addition, to check the growth of the funds in good economic times, the FDIC should be permitted to rebate funds gradually.

In addition to these two key flaws in the deposit insurance system, my testimony will address two other important issues. First, the BIF and the SAIF should be merged. As long as the FDIC maintains two deposit insurance funds, whose assessment rates are determined independently, the prospect of a premium differential and the attendant inefficiencies and inequities exists. A combined deposit insurance fund would be stronger. Moreover, because each insurance fund now insures both banks and thrifts, there is little justification for maintaining separate funds.

The second issue is the erosion in the real value of deposit insurance over time. Because deposit insurance is an important component of the federal government's program to promote financial stability, the FDIC's recommendation, described in more detail below, is that the coverage limit be indexed to maintain its real value over time.

FDIC RECOMMENDATIONS

The current statutory restrictions on the FDIC's ability to charge risk-based premiums to all institutions should be eliminated; the FDIC should charge premiums on the basis of risk, independent of the level of the fund.

Insurers generally price their product to reflect their risk of loss. For example, everyone is aware that automobile liability insurers charge higher premiums to drivers who are more likely to be involved in accidents. Insurers also adjust the premiums over time on the basis of factors such as age, experience and driving record. The inability of the FDIC to charge premiums that reflect the risk of individual institutions, results in approximately 92 percent of insured institutions paying no premium for their deposit insurance coverage.

Currently, there are significant and identifiable differences in risk exposure among the 92 percent of insured institutions in the best-rated premium category. Indeed even institutions with different CAMELS ratings (1 and 2) pay the same amount for insurance—zero. With institutions with different risk characteristics all paying nothing for insurance there is reduced incentive for banks to avoid risk. Since all institutions will pay premiums if the fund falls below the DRR, the current system in effect forces safer institutions in the best-rated premium group to subsidize the riskier ones.

The absence of deposit insurance premiums also creates an incentive to bring new deposits into the system at the expense of existing institutions. As I mentioned earlier, there are over 900 newly chartered institutions that have never paid premiums. In

addition, financial institutions outside the realm of traditional banking recently began to make greater use of FDIC-insured deposits in their product mix. Large dollar volumes of investment firm brokerage accounts were swept into deposit accounts in their FDIC-insured subsidiaries. To the extent that these institutions are in the best-rated premium category, they pay no insurance premiums for this rapid growth.

To avoid a procyclical bias, sharp premium swings triggered by deviations from the DRR should be eliminated.

Current law requires the FDIC to price deposit insurance in a way that can result in severe and unexpected premium changes. Ideally, if the deposit insurance fund falls below a target level, premiums should be increased gradually. If the deposit insurance fund grows above a target level, funds should be rebated gradually.

If risk-based premiums are to be assessed at all times, then the related issue of how large the deposit insurance fund should grow must be addressed. Determining the appropriate size for the deposit insurance fund involves a trade-off. The fund serves vital purposes—protecting taxpayers from loss, ensuring that adequate resources are readily available when problems arise, and helping to smooth the costs of deposit insurance over time. The smaller the fund, the higher premiums will need to be under adverse scenarios in order for the solvency of the fund to be maintained. On the other hand, if the goals are to avoid any risk of insolvency and to protect the taxpayer from any risk of loss, even from the proverbial “hundred-year flood,” the fund would probably have to be very high.

This would remove money from the banking system that otherwise could be put to use by the industry.

On balance, the existing 1.25 percent reserve-ratio target that the Congress selected appears to be a good starting place, either as a fixed target or as the midpoint of a range. It has worked well since the insurance funds were recapitalized, although it has yet to be tested in an economic downturn. In any case, neither the DRR nor the size of a range should be fixed permanently. It would be wise to revisit the performance of the fund and general economic conditions every few years and adjust accordingly.

It also should be noted, that other approaches to determining fund adequacy are possible. The current statutory target, the DRR, is defined relative to estimated insured deposits, but the target could be expressed analytically, for example, in terms of the risk exposure of the fund.

Rebates should be determined on the basis of past contributions to the deposit insurance fund, not on the current assessment base.

Under current law, the FDIC's ability to affect the insurance fund's reserve ratio is limited to changing deposit insurance premiums. The FDIC has never had authority to pay rebates out of the insurance fund.² Changing the current system to allow the FDIC to

² The FDI Act of 1950 gave the FDIC the authority to return *current* assessment income to insured banks in years in which assessment income exceeded losses and expenses. From 1950 through 1984, the FDIC provided assessment credits to insured banks, lowering the effective deposit insurance premium paid by banks from the statutorily mandated annual premium rate of 8.33 basis points. When the system of risk-based premiums was established in 1993, this authority was eliminated. The Funds Act provided for

pay rebates to institutions that have paid premiums in the past would create a self-correcting mechanism to control the growth of the fund. Such a mechanism would allow the FDIC to assess premiums at levels appropriate to the risks posed by individual institutions while providing credit for past contributions. For these reasons, the FDIC recommends that, if the fund grows above a target level, a portion of the excess funds should be rebated.

However, it is important that rebates do not create perverse economic incentives. A rebate tied to the current assessment base would work at cross purposes to risk based premiums and increase moral hazard and could even result in situations where banks are paid to grow. Fairness dictates that rebates should be based on past contributions to the fund.

The BIF and the SAIF should be merged.

The FDIC currently administers two deposit insurance funds: the BIF and the SAIF. Each provides coverage of up to \$100,000 per depositor (in each ownership right and capacity), per institution. While both operate under the same statutory assessment system, assessment rates for the BIF and the SAIF are required by statute to be set separately. Although the FDIC uses several factors to set these assessments, the most significant determinant under current law is each fund's reserve ratio.

refunds of *current* BIF assessment income to well-managed, well-capitalized institutions. Since these institutions currently do not pay premiums, there is no refund.

When a fund's reserve ratio falls below the DRR, the FDIC must raise premiums by an amount sufficient to bring the reserve ratio back to the DRR within one year. If this is impractical, the FDIC must charge a premium of at least 23 basis points until the reserve ratio meets the DRR. Conversely, when a fund's reserve ratio exceeds the DRR, well-capitalized, well-managed institutions pay no premiums.

The BIF and the SAIF provide an identical product—deposit insurance. Yet, as long as there are two deposit insurance funds, whose assessment rates are determined independently, the prospect of a premium differential exists. When an identical product is offered at two different prices, consumers—in this case, banks and thrifts that pay deposit insurance assessments—naturally gravitate to the lower price. This phenomenon was observed before the passage of the Funds Act when some SAIF-insured institutions successfully shifted deposits to BIF insurance. Despite moratoria, entrance and exit fees, and bans on deposit shifting, market forces ultimately prevailed. Inefficiency and waste were introduced as institutions expended time and money trying to circumvent restrictions that prohibited them from purchasing deposit insurance at the lowest price. Although the Funds Act led to the elimination of the premium disparity that then existed between the BIF and the SAIF, only a merged fund can guarantee that such a disparity will not recur. A merged fund would have a single assessment rate schedule whose rates would be set solely on the basis of the risks that institutions pose to the single fund. The prospect of different prices for identical deposit insurance coverage would be eliminated.

It should be noted that, although the two funds originally were intended to insure bank and savings association deposits separately, today both funds insure deposits at both types of institutions. Moreover, many institutions currently hold both BIF- and SAIF-insured deposits. More than 40 percent of SAIF-insured deposits now are held by commercial banks. Merging the funds could eliminate the costs to insured institutions associated with tracking their BIF and SAIF deposits separately, and the complications this introduces for mergers and acquisitions. These factors, in tandem with the reasons discussed above, have led the FDIC to recommend for many years that the BIF and the SAIF be merged.

The deposit insurance coverage level should be indexed to maintain its real value.

A primary purpose of deposit insurance is to give depositors a safe place to save, invest and manage their accounts without the burden of monitoring the financial condition of their banks. Federal deposit insurance is important, not only to individuals and families, but also to the many small businesses, charities and local governments that commonly rely on insured depository institutions.

The Congress has changed the level of coverage six times since 1934. However, in the past 21 years, the real value of the current \$100,000 coverage limit has fallen by approximately half, on the basis of the Consumer Price Index (CPI). The real value is now less than it was in 1974, when the nominal coverage limit was increased to \$40,000.

Deposit insurance is an important element of the government's overall effort to promote public confidence in the banking system and, as such, should not be allowed to erode in value. While Congress should decide on the initial coverage level, indexing would provide a systematic method of maintaining the real value of deposit insurance coverage. An indexing system would be consistent with the treatment of other federal programs and would lessen the potential for large, sudden changes in the coverage limit.

IMPLEMENTATION ISSUES

How the recommendations for risk-based pricing and rebates would work.

The paper the FDIC published last month contains specific examples that illustrate how these recommendations might be implemented. The examples are intended to help focus the discussion and clarify the questions that need to be answered in implementing the proposals—not as a definitive conclusion about the answer to all those questions.

In the recommendations that the FDIC has put forward regarding the setting of premiums, there would be regular risk charges that the FDIC would assess regardless of the level of the insurance fund. In the examples, these charges for most institutions would be either one basis point per annum or three basis points per annum of the assessable deposit base. The specific amount paid by an individual institution would depend on its risk profile.

When the insurance fund exceeds some threshold, a portion of the excess would be rebated to insured institutions. In the example, the threshold above which rebates begin is 1.35 percent of the deposits insured by the fund, and the portion of the excess that is rebated is 30 percent. When the insurance fund falls short of some threshold, a portion of the shortfall would be recovered by a surcharge on insured institutions. In the example, the threshold below which surcharges begin is 1.15 percent of insured deposits, and the portion of the shortfall that is assessed in the form of a surcharge is 30 percent. Thus, in the example, when the fund is between 1.15 percent of insured deposits and 1.35 percent of insured deposits, there would be no rebates or surcharges, only the basic risk charges. Rebates and surcharges act as a self-correcting mechanism that tends to push the deposit insurance fund back to the chosen range.

The FDIC simulated the effect of these assumptions on insured institutions and the insurance funds. Assuming the FDIC recommendations were in place throughout the year, the estimated year-end 2001 rebate would be approximately 1.4 basis points of the total assessable deposits of insured institutions.

As discussed earlier, the amount of an individual institution's rebate would depend on how much it paid in assessments in the past. Notwithstanding this individual variation in rebates, the FDIC's simulation illustrated a noteworthy feature. The typical bank in the best-risk category that paid a premium of one basis point would receive a rebate that is larger than its premium. This might apply to approximately half of all institutions currently in the FDIC's best or 1A insurance category. Roughly, another 30

percent of these institutions would pay three basis points, but receive, again, a rebate that averaged 1.4 basis points.

Under a high-loss scenario with losses comparable to actual losses experienced during the last banking crisis, the FDIC estimated that premiums for institutions in the best-risk category might rise to approximately 11 basis points, significantly less than the 23 basis points required under current law. This occurs because, in the example, premiums rise more gradually during an episode of high insurance losses as the insurance fund temporarily absorbs some of the losses. The result is that banks and thrifts would have billions of additional dollars to lend. This is a critical feature of the FDIC's recommendation and one that will enhance the ability of banks and thrifts to support economic recovery in the event of a downturn.

Another simulation provided insight into the behavior of the insurance fund during favorable economic environments. Even with the extreme assumption of no insurance losses whatsoever, the fund never rose above 1.50 percent of insured deposits over the 10-year simulation period. This type of check on fund growth occurs by design. The higher the fund gets, the larger the rebate, thus rebates eventually would exceed assessment income and provide a brake on the growth of the insurance fund.

Setting premiums. In a deposit insurance system with rebates such as the one proposed by the FDIC, the financial impact of the system on insured institutions cannot

be measured adequately by focusing on premiums alone. Premiums are only half the equation. Rebates are the other half.

The FDIC was guided by a number of considerations in developing its recommendation regarding the setting of risk-based premiums. Because all depository institutions present some risk, all insured institutions should pay at least some small premium. As in other types of insurance, the FDIC calculated premiums on an expected-loss basis. Under an expected-loss method, premiums from any given risk group cover the losses that that group experiences, on average.³

In the example detailed in the recommendations, the FDIC used a statistical failure-prediction model as the basis for a scorecard that assigns depository institutions into risk categories. Such an approach has the advantage of being based on objective factors. In the private sector, similar modeling approaches are used to score loan applicants or to estimate default rates on obligations of public or private entities.

The scorecard, which uses examination ratings and financial ratios, appears to work well for the great majority of depository institutions in the sense that institutions with the best scores have consistently experienced the lowest rates of failure. Conversely, institutions with the worst scores have consistently experienced the highest rates of failure. Although there is room to improve and refine the scorecard, it could

³ In the case of pricing deposit insurance, a complication arises because the expected-loss premiums for the riskiest depository institutions are likely to be so high as to cause additional failures. Thus, in the example, premiums for the riskiest depository institutions are substantial, but are capped.

form a sound basis for risk differentiation for the thousands of small banks whose historical experience underlies the analysis.

This approach needs to be modified for assigning large, complex institutions to risk classes for deposit insurance. Many of these institutions have continuous on-site supervision, are monitored by ratings agencies, and have debt and equity whose prices may reflect useful market signals about risk. Moreover, their risk characteristics most likely do not fit neatly into the same statistical profiles, as is the case for small banks. Although it would require an analysis of different factors, the approach to pricing for large, complex institutions would be designed to achieve the same goal of reflecting the risk of this class of institutions.

While any approach must accommodate the inherent differences between large and small banks, the FDIC does not believe it is appropriate to otherwise differentiate systematically among institutions on the basis of asset size alone for purposes of setting deposit insurance premiums. For example, if small banks currently rated 1A were divided into three risk groups paying one, three and six basis points, large banks rated 1A should be similarly divided. There is no reason to expect that the distribution of large banks among these three risk groups would be significantly different from the distribution of small banks.

Setting a target level for the fund. The example in the FDIC's recommendations relies on surcharges and rebates to bring the fund back toward a range between 1.15

percent of insured deposits and 1.35 percent of insured deposits. Within this range, depository institutions would pay constant risk-based premiums. The range could be larger or smaller. An alternative approach would involve a single target reserve ratio, with rebates or surcharges equal to some percentage of the difference between the actual reserve ratio and the target ratio

A trade-off exists between a range, on the one hand, and a fixed reserve ratio, on the other. Other things equal, a range seems more consistent with smoothing insurance losses over the business cycle. It provides greater certainty with regard to premiums because it allows a fund to absorb more losses before surcharges take effect, and it allows for a larger fund to absorb losses before rebates are instituted. On the other hand, since a fixed reserve ratio results in surcharges whenever the fund is below a particular ratio, and rebates whenever the fund is above that ratio, it tends to move the fund back to a specific reserve ratio faster. Also, to the extent that rebates provide established institutions with some credit for their past contributions, rebates are paid sooner with a fixed reserve ratio.

In the case of both a range and single target, a cap on the size of the fund above which all funds are rebated to the industry might be considered. Similarly, it might be prudent to establish a floor below which all losses would have to be covered relatively quickly by the industry. These boundaries would help to ensure that a fund would not excessively grow or shrink relative to its target ratio.

Setting rebates. Rebates should be tied to the amount of premiums that a depository institution paid in the past. By contrast, tying rebates to the current assessment base would give institutions an incentive to grow in order to get a larger rebate—potentially far in excess of anything individual institutions ever contributed to the funds. Quite apart from the perception, and perhaps the reality, that some depository institutions would be getting “something for nothing” under such a system, there would be a severe distortion of economic incentives that would exacerbate moral hazard and the potential for dilution of the insurance funds from new deposits.

Tying rebates to past contributions to the fund raises certain issues both in terms of the initial allocation of rebates and the method of updating eligibility for rebates going forward. First, the time period for calculating past contributions needs to be determined. In this regard, reliable data only begin in 1984. Second, how should mergers and failing-bank acquisitions be treated? Finally, how should the special assessment that fully capitalized the SAIF be treated? None of these problems is insurmountable, however, and it is possible to develop reasonable rules for determining the initial rebate allocation.

Over time, premiums paid by individual banks would presumably change the allocation of rebates. One possibility is to track premiums received and rebates paid, so that, at any time, rebates could be calculated on the basis of past payments to the fund. A crucial issue is how far back institutions would be given credit for premiums they had paid. If there were no limit on this look-back period, it would take decades for a new institution’s rebate share to catch up with that of its older competitors. An alternative

would be to base rebates on an institution's share of total premiums paid over a period of years. In any case, the longer the lag, the longer it will take new institutions to catch up.

There are three additional questions to take into account in designing a rebate system. First, should rebates be limited so that, for any institution, premiums paid minus rebates received over some defined number of years should never be negative? Second, should the additional premium an institution pays because of its above-average risk category count toward a rebate? One possibility is to give institutions credit only for premiums they would have paid had they been classified among the safest institutions. Finally, should banks in certain risk categories get a rebate at all? For example, it may not be appropriate for problem banks to get a rebate.

Treatment of rapidly growing institutions. Recent developments have highlighted the concern raised by rapidly growing institutions that dilute the reserve ratio and pay nothing for deposit insurance. The FDIC's recommendations address this issue in several ways. First, by eliminating rapidly escalating premiums when the fund falls below the DRR, the adverse effect of new deposit growth on other insured institutions would be diminished substantially.

Second, regular risk-based premiums for all institutions would mean that fast-growing institutions would pay increasingly larger premiums as they gather deposits. In

addition, fast growth, if it posed greater risk, could result in additional premiums through the operation of the FDIC's expanded discretion to price risk.

Finally, if rebates are paid on the basis of past contributions, net payments to the FDIC from fast growers would be greater than for established institutions or institutions growing more slowly. Over time, if rebates were made on the basis of past assessments, funds from more recent assessments would replace funds from older assessments and new institutions would become eligible for rebates on the basis of the premiums they paid.

Indexing deposit insurance coverage.

Two questions must be answered in order to implement indexing: What index should be used, and when should the level be adjusted? There are numerous possible indices, including price, wealth, and income. For pragmatic reasons, the FDIC believes that the Consumer Price Index would be appropriate. It is widely understood and accepted and is readily available. It also captures inflation reasonably well.

There are many possible rules for deciding when to increase the coverage limit, including the passage of time and significant declines in the coverage limit's real value. A combination of a minimum period of time between coverage limit increases and a minimum percentage decline in the real value of the coverage limit seems to work best.

Any system that is developed should have a safety-valve feature for periods of extraordinary inflation.

The FDIC believes that coverage limits should be stated in round numbers, such as to the nearest \$5,000. Coverage limits also should not be allowed to decrease. A decline would require the public to monitor the insurance limit in order to avoid losing insurance for a portion of their funds, thus placing an unnecessary burden on the public. Moreover, if coverage limits were allowed to decrease, uncertainty might be created, thereby undermining the purpose of deposit insurance.

Some have suggested that higher coverage limits would be appropriate for certain types of deposits, such as municipal deposits and IRAs, and that the FDIC should explore optional excess coverage for all deposits. The potential benefits and consequences of favoring some deposits with higher coverage limits are uncertain, but it is the FDIC's view that these proposals should be explored further, through additional analysis and discussions among the interested parties.

CONCLUSIONS

Today's strong economy and banking system provide a window of opportunity to improve the deposit insurance system. It would be a missed opportunity to wait until the economy and the banking industry are suffering and the results of the weaknesses in the deposit insurance system have become all too evident. The FDIC's recommendations

will strengthen the deposit insurance system, promote economic stability, enhance safety and soundness, and make the system more equitable.

It is also important to note that these reforms will work best if implemented as a package. In particular, the ability to price for risk is essential to an effective deposit insurance system. Picking and choosing among the parts of the proposal could weaken the deposit insurance system, magnify macroeconomic instability, and distort economic incentives. Trying to address other issues without addressing risk pricing does not solve one of the most fundamental flaws in the current system.

I would like to thank Chairman Bachus, Representative Waters, and Members of the Subcommittee once again for the Subcommittee's interest in this important issue and for the opportunity to present the FDIC's reform proposals. The FDIC looks forward to working with this Subcommittee and the Congress, as well as with the banking industry and the public, to improve the deposit insurance system.